Inflation Persistence and Optimal Positive Long-run Inflation*

Dario Pontiggia†

University of Glasgow, University of Milano-Bicocca

First draft: May 2007

This draft: November 2008

Abstract

Within New Keynesian economics, the optimality of a monetary policy that aims at zero inflation is surprisingly robust. Full price stability is optimal despite the inefficiency of the nonstochastic steady state and the existence of a positively sloped long-run Phillips-curve trade-off. Even under inflation persistence due to backward-looking price indexation by price setters, zero inflation remains optimal. We show how backward-looking rule-of-thumb behaviour by price setters results in optimal positive long-run inflation. The features that seem capable of delivering an endogenously optimal positive inflation target are costly disinflation, long-run Phillips-curve trade-off, and steady-state distortions.

JEL classification: E31, E52.

Keywords: Optimal monetary policy, inflation persistence.

*I am very grateful to Michael Woodford for his comments on the first draft of this paper. I am grateful to Campbell Leith, Anton Muscatelli, Patrizio Tirelli, and participants at the "Monetary Policy and the Business Cycle" conference at the University of Milano-Bicocca for valuable suggestions and comments. I thank Ioana Moldovan and Jon Steinsson.

†If there are errors, I am solely responsible. Special thanks to those who know for love and game. E-mail: 0412182p@student.gla.ac.uk. Address: Economics Department, Adam Smith Building, 40 Bute Gardens, G12 8RT, Glasgow, UK.